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Feature

Bush's Tax Plan—The Dangers

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"Seldom have so few gotten so much from so many." That might be the motto of President Bush's proposed tax cuts.

As the nation entered the new millennium, it faced three problems. First, the economy was slowly going into a recession, with a stock market bubble about to burst. Second, inequality was growing. While the Nineties had at last arrested the decline in income of those at the bottom of the income distribution, the fruits of that decade's growth went disproportionately to the rich. Third, there were long-range problems, including Medicare and Social Security systems that were underfunded and an economy that had become addicted to living beyond its means, borrowing more than a billion dollars a day from abroad.

While Bush inherited these challenges, he started with one advantage that Clinton had not had. Bush senior had bequeathed to Clinton a serious deficit—8 percent of GDP, if one excludes the money that was supposed to be going into Social Security. But Clinton bequeathed to Bush junior large surpluses. These surpluses might have been used to shore up our Social Security and Medicare system. They might have provided badly needed new benefits, like long-term care and prescription drugs. They might have been used to repair America's infrastructure, our aging highways, bridges, and airports. The burst of growth in the Nineties was based on new technologies and progress in science; and yet, even here, we underinvested, because of pressure to meet deficit targets.

As President Bush took office, he took advantage of the economic downturn to push for a tax cut, but it was a tax cut that was not designed to stimulate the economy—and it did not do so to any appreciable degree. Two years later, the economy is still languishing. The cost of Bush's mistake has been enormous. In 2001 alone, we had a gap of some 3 percent between the economy's potential and what it actually produced, which translates into a loss of \$300 billion. And there is strong evidence that as success breeds success, failure breeds failure: if the economy's output is lower today because of this mismanagement of national economic policy, it will be lower

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five, ten, twenty years from now, since some of the lost output would have been spent on investments that would have enhanced productivity.

The first order of business—then and now—should be a tax cut that stimulates the economy. All the better if we can have a stimulus that not only enhances growth but also addresses our long-term problems, including our growing inequality. In fact, it must have been hard for Bush to design a tax program that cost so much in revenue while at the same time doing so little to stimulate the economy.

Two arguments are being made to defend Bush. The first holds that he is not to be blamed for the country's current economic difficulties: Who could have predicted that the downturn would have lasted so long? But many (myself included) did predict this, for an obvious reason. Underlying the economic downturn was huge overinvestment in high-tech and telecommunications companies, the sectors that had sustained the economy during the Nineties. It would be years before we worked off the excess capacity that resulted from such overinvestment. Meanwhile, it was unlikely that the lowering of interest rates by the Federal Reserve would have much effect; firms with excess capacity are not going to build still more excess capacity just because they can borrow more cheaply.

But there is a more fundamental answer to Bush's defenders: the art of economic policymaking is knowing how to respond to uncertainty. America has one of the poorest unemployment insurance schemes among the advanced industrial countries, with more limited coverage, and benefits that are both shorter (only twenty-six weeks) and lower. Improving those benefits would have provided an automatic stabilizer at a time of economic slowdown—money would be spent only if the unemployment rate increased, especially the long-run unemployment rate, which doubled in Bush's first two years.

Eventually, unemployment benefits were extended for another thirteen weeks, but only until the end of 2002. By then, the extended benefits of almost a million Americans had run out, and three quarters of a million more workers faced a cutoff of benefits after Congress initially failed to renew an extension. It was not just that the Bush administration and the Republican Congress had heightened the anxiety of almost two million workers during the Christmas holidays, but in doing so, the administration further undermined the strength of the economy. It was no accident that the Christmas shopping season of 2002 was a weak one. Unemployment benefits have at last been extended, but there is room to extend them further, much further.

A second argument that needs to be disposed of is one put forward by Bush himself: if the tax cuts were good enough to be passed in May 2001, it makes sense, so he has said, to accelerate them now. The duplicity in the argument should be obvious: by the same logic one could have argued that since the sunset provisions of the first Bush tax law, under which some of the key provisions, like the elimination of the estate tax, are to terminate in 2010, were good enough to be enacted in 2001, why not make them permanent? The reason for the terminal date was simple: the country could not afford to make the changes in the law permanent, even when we thought we had huge permanent surpluses. If we could not afford them then, do we really believe we can

afford them now? Even if we ignore the unequal distribution of the benefits, many economists were not convinced that the tax cuts were a good thing even then.

But since then, we have two more pieces of information. We know that the tax cuts were ineffective in stimulating the economy. Why should we believe that accelerating them even faster will do much more for the economy? The tax cuts were oversold as a stimulus; and now we know they failed.

Secondly, in May 2001 we thought we had a surplus, not counting the money that was supposed to go into the Social Security trust fund, of some \$3 trillion over the next ten years. During the Clinton administration, we thought that the surplus would protect Social Security and Medicare, finance needed investments, and help pay down the national debt.

In an astonishing feat of fiscal mismanagement, the Bush administration managed to squander that surplus, converting it into a \$2 trillion deficit. Some of this was not entirely Bush's fault. Even with the best of fiscal management there was a good chance the projected surplus wasn't ever likely to be realized. But that's exactly the point. Bush spent money that we did not have. It was reckless to do so. When I was chairman of the Council of Economic Advisers, I saw how those budget projections are made; I know how fragile they are. They rest on a set of hard-to-believe assumptions. Slight changes—such as a slightly slower growth rate than anticipated—can have big consequences. Bigger changes could have even bigger consequences, for example the bursting of the stock market bubble that had led to huge increases in capital gains tax revenue. The projections were too good to be believed and it should not have been surprising that they turned out to be wrong.

Now that we know our true fiscal situation more accurately—it is likely worse than the \$2 trillion deficit "officially" being projected—it is even more reckless to continue on a tax-cutting spree. But Bush's new economic proposals seemingly put aside all budgetary restraints. The new budget envisages a turnaround in the fiscal situation for the period between 2002 and 2011, from a huge ten-year surplus to an even bigger ten-year deficit—a difference of some \$7 trillion. The administration thus anticipates huge deficits, even years after the economy recovers from the recession. For the year 2008 alone (even with misguided economic policy the economy will surely recover by then!) it expects a \$190 billion deficit.^[1]

We know how to create a powerful and effective tax stimulus. What is needed is to give money through the tax system to those who will spend it and spend it quickly: the unemployed, the cities and states that are starving for funds, and lower-income workers. A strong stimulus would also be an equitable stimulus: the money, by and large, goes to the poorest Americans, those who have benefited least from the growth of the last quarter century. Giving money to cities and states will prevent cutbacks in educational and health expenditures, which can hit the poor particularly hard.

We also know how to get more benefit per dollar of tax relief. An investment tax credit, for instance, could be incremental, going only to corporations and individuals that increase their investments. When I was at the Council of Economic Advisers, we thought of a variety of other "low-cost" stimuli— for instance, allowing firms that

invest more to "carry back" profits and losses from previous years, so that they can get a credit or refund on taxes previously paid. Such a stimulus even increases overall economic efficiency. (By contrast, the Bush proposal restricts carry-back provisions to firms that want to qualify for tax-free dividends.)

By now, it is well known how Bush's tax package favors the rich, but the degree to which it does so is not well appreciated. While 50 percent of all tax filers would receive \$100 or less, and two thirds \$500 or less, Bush himself, according to Bloomberg News, would have saved \$44,500 on his 2001 tax returns, and Cheney \$326,555. According to an estimate in the *Financial Times*, John Snow, Bush's secretary of the Treasury, would save some \$600,000. The calculations of the Brookings Institution Tax Policy Center show that more than half of the benefits of exempting corporate dividends from the individual income tax would flow to the top 5 percent of the population. All the taxpayers in that group earn more than \$140,000 and they have an average income of \$350,000. The 226,000 richest tax filers, those with incomes over \$1 million, will receive a benefit roughly equal in size to the 120 million tax filers with incomes below \$100,000.^[2]

The inequity arises not just from the fact that the rich own most of the country's dividend-paying stocks, but also from the fact that average working Americans hold stocks largely in pension funds, IRAs, and other forms of investment that are already tax-exempt. For the average American, corporate earnings are not being double-taxed. The problem is that too often such earnings are not even subject to a single tax as more and more American corporations have learned how to avoid paying corporate income taxes. Today, using these techniques, the average American corporation pays a far lower proportion of its profits in federal income taxes than was the case in the past, and at a lower rate than the one prescribed by the tax statutes. (For many rich Americans, moreover, even capital gains in taxable accounts entirely escape taxation, by means of a provision in the tax law called "step up of basis at death." In effect, when a person dies, the appreciation in a stock he holds goes untaxed.)

The notion that the average American would benefit from the Bush program is just more of the old, and discredited, trickle-down theory: give money to the rich and "eventually" the poor will benefit. It didn't happen in the Eighties, and there is no reason to believe that it will happen now.

Clearly, with the rich receiving the main benefits, Bush's program would lead to economic growth only if investment were stimulated. The problem is that this is unlikely; and remarkably, even President Bush's Council of Economic Advisers seems to agree.^[3] In their generally rosy account of the economy's future, they predict that the tax program will create only 190,000 jobs this year. That's just a little over half of the number of new jobless claims filed each month, and only a tenth of the net number of private-sector jobs that have been lost since Bush took office.

More remarkably, Bush economic advisers predicted (before they took the study off their Web site) that as the deficit and interest rates increase, between 2005 and 2007 the Bush program will actually lead to reductions in job growth relative to what they otherwise would be. Their optimistic account projects the economy's output to be no

more than one percentage point higher than it would have otherwise been—five years later. But the slow growth of the last two years has put us more than five percentage points below what would have been the case had the growth of the Nineties been sustained. In short, the Bush plan does little to close the gap between how the economy has been performing and its potential.

There are many reasons why we should not be surprised at the anemic expected response of the economy to the dividend tax cut. If investment has responded so weakly to lower and lower interest rates, why should we expect it to respond to an ephemeral increase in stock market prices—even should that happen? As we have watched the market's response to Bush's proposal, even the notion that stock prices would get much of a jolt has seemed more and more like fantasy. Typically, a major proposed change in tax laws (if it seems likely to be passed) has its most significant effect on stock prices at the time of the announcement or shortly thereafter. If investors believe that the tax cut will lead to higher stock prices when it is enacted, they anticipate that effect, and bid up the price today. In the case of Bush's proposed tax cut, there was a small, one-day effect, but it quickly disappeared.

To me, this came as no great surprise. As I have pointed out, for most Americans the dividend cut will make absolutely no difference since they pay no taxes on shares owned by their 401k plans or through pension funds. In addition, vast amounts of shares are owned by universities and foundations; since they, too, pay no taxes, their demand for shares will not increase. Many foreigners, whose waning confidence in the American economy may have contributed to the recent downturns in our stock market, will also be little affected; they often receive a credit on their own taxes against taxes paid in the US; so as their payments to the US go down, their payments to their own tax authorities go up.

The dividend tax cut makes a difference mainly for very rich Americans, with large inheritances and with substantial holdings of shares beyond their retirement programs. Their demand for shares will increase, and this will tend to increase stock prices—though the price increase will be offset by the fact that other investors, receiving no benefit from the dividend tax exemption, will find shares less attractive at the higher price, and they will switch their funds to other investments.

Two other forces may not only further limit any increases in stock prices, but actually may lead to their fall. The tax cut, coming on top of the irresponsible tax cut of 2001, which converted our multi-trillion-dollar surpluses into deficits, will further undermine confidence in US fiscal management, by both Americans and foreigners. Even ignoring such psychological factors, the recent study by William Gale and Peter Orszag shows convincingly that increases in deficits are associated with increases in interest rates.¹⁴ (This is not a surprising result for anyone who believes in basic economics: an increase in the demand for funds leads to an increase in the price of funds, in this case, interest rates.) Higher interest rates lead to lower share prices.

Moreover, there is a longstanding argument that the dividend tax has little impact on investment (or on economic efficiency). Most new corporate investment is financed either by retained earnings or by borrowing. A firm that borrows \$100 to make an

investment deducts the interest payment from taxes. If it borrows at 10 percent, and is in the 35 percent tax bracket, then the net cost to the firm of capital is 6.5 percent. If there were no corporate tax, it would pay for the firm to borrow if the investment earned a return of 10 percent. With taxes, it pays to borrow if the investment earns a net return of 6.5 percent—or a gross return of 10 percent—exactly the criterion it would have used in the absence of taxation. With interest deductibility, the corporate income tax does not act as a brake on investment, provided that depreciation allowances for decline in the value of assets as they age are accurate. In fact, the depreciation rates allowed under US tax laws are (relative to true depreciation, that is, the true decrease in the value of the asset) somewhat generous, suggesting that the tax system has a slight bias in favor of investment, especially in long-lived assets.

But let us grant Bush his argument that somehow eliminating the dividend tax will raise share prices and stimulate investment by dividend-paying firms. It is still unlikely to do much to stimulate the economy in the short run—and it is likely to repress growth in the long run. Most firms raise capital to finance new investment not by issuing new shares, but by borrowing, and with the higher interest rates, investment will be more expensive.

The Bush tax program would be of much less benefit to the New Economy firms, the high-technology enterprises which are at the center of America's recent success, than to the Old Economy firms, the railroads and aluminum companies, from which Bush has drawn his secretaries of the Treasury. For unlike the Old Economy firms, those in the New Economy pay out little in dividends. (They would benefit a little from Bush's new proposals concerning the calculation of capital gains for tax purposes, but the extent of the benefit would be much smaller, precisely because the effective capital gains tax is so much lower.) In effect, the new tax proposal tilts the economy toward the slow-growth sectors—not exactly a strategy designed to promote long-run prosperity.

Overall, national savings will be reduced as the deficit increases. It is likely that we will wind up borrowing more abroad. Owing to a variety of factors—including higher interest rates and lower national savings—the incomes of Americans will be lower. According to the estimate of Gale and Orszag, by 2012 they will be lower by 1.8 percent, or \$1000 per capita: and while the tax benefits go to a few rich Americans, the burden of this lower income will be felt by all of them.

While the Bush tax plan may do little to stimulate investment or consumption, it could hurt the economy in other ways. Many states and localities base their taxes on the provisions of the federal tax code, so a federal tax cut translates directly into a revenue cut for them. They will cut back their expenditures and increase their taxes, and this too will depress the economy. But higher interest rates and higher property taxes can have an additional damaging effect: they can prick the real estate bubble, the one thing which has kept the economy going.

The dividend tax cut is the most egregious component of the Bush plan, but there are others. The new, expanded IRAs provide another example of how one can give large benefits to the rich without stimulating the economy. For the average American,

current, or perhaps slightly expanded, IRAs are likely to be adequate to absorb all the savings they want to, or can, make. But the rich can simply transfer money from current taxable accounts into tax-exempt IRA accounts. They don't have to save any more to take advantage of this bonanza. Little noted is the fact that were this program adopted, it would make the dividend tax exemption even more regressive, for even people in the upper-middle-income brackets would be able to avoid taxes on their dividends. The dividend tax exemption then becomes a truly targeted tax cut — targeted at conferring benefits on the very rich.

If I were making a list of tax cuts to stimulate the economy, the dividend tax cut would not make the short list. Nor would I put the dividend tax cut and Bush's other proposed measures on a list of basic reforms to make our tax system less complicated, promoting growth and equity.

What is most impressive about the Bush tax proposals is the sheer brazenness with which they have been sold. Evidently thinking that the average American would not be able to understand statistics, the administration has presented the tax cuts by citing the average benefit it will bring — hoping that the average American will think that he will get the average tax benefit. But when hundreds of thousands of dollars in benefits go to a small group of people, the average may be a large number; that's why the impact on the deficit is so large. The average American will still get close to nothing, less than \$100. Such brazenness has served the leaders of the Bush administration well in the past: they used it to get through the huge tax cut for the rich that the country could ill afford in May 2001. Too many legislators, political leaders, and commentators who had long stood for fiscal responsibility and good tax policy were simply intimidated. Let us hope they have now learned that Bush's proposals will do grave damage to the economy and the country.

— February 12, 2003

Notes

^[1] See William G. Gale and Peter R. Orszag, "America Cannot Afford a Huge Deficit," *Financial Times*, February 5, 2003.

^[2] See Joel Friedman and Robert Greenstein, "Exempting Corporate Dividends from Individual Income Taxes," Center for Budget and Policy Priorities, January 6, 2003.

^[3] See Council of Economic Advisers, "Strengthening America's Economy: The President's Jobs and Growth Proposals," January 7, 2003. (The report mysteriously disappeared from their Web site sometime after commentators noted these implications of its analysis. After the numbers were appropriately massaged, it reappeared, with stronger claims for job gains in 2003.)

^[4] See William G. Gale and Peter R. Orszag, "The Economic Effects of Long-Term Fiscal Discipline," Urban-Brookings Tax Policy Center Discussion Paper, December 17, 2002; and Gale and Orszag, "America Cannot Afford a Huge Deficit."